

September 3, 2020
 via email

Mr. Joe Gimenez
 Windermere Oaks Water Supply Corporation
 424 Coventry Road
 Spicewood, TX 78669

Subject: Financial Assessment

Dear Mr. Gimenez:

NewGen Strategies and Solutions, LLC (NewGen) performed a high-level financial assessment of Windermere Oaks Water Supply Corporation (WOWSC) to document the impact of the lawsuits on WOWSC’s financial position and provide possible financial policies that may benefit the utility.

Recent History

NewGen reviewed the financial results for 2017, 2018, and 2019 to assess WOWSC’s recent financial history. The following tables provide a summary of WOWSC’s financial condition as measured by various common benchmarks over the past three years. It is important to recognize that WOWSC’s involvement in two lawsuits brought against WOWSC by TOMA Integrity, Inc. and by Rene Ffrench, John Richard Dial, and Stuart Bruce Sorgen have placed significant strain on the financial condition of the utility. Further, WOWSC is currently defending its March 2020 rate change, necessitated by legal expenses, at the Public Utility Commission of Texas (PUCT). WOWSC’s future financial condition depends on the duration and outcome of its various legal challenges.

Table 1
 Leverage Ratios

	2017	2018	2019
Debt to Capitalization			
Debt	\$ 388,064	\$ 357,549	\$ 331,989
Equity	1,177,136	1,179,199	1,128,317
Total	\$ 1,565,199	\$ 1,536,748	\$ 1,460,306
Ratio	25%	23%	23%
Debt to Net Plant Assets			
Debt	\$ 388,064	\$ 357,549	\$ 331,989
Net Asset Value of Plant	1,396,139	1,363,874	1,285,272
Ratio	28%	26%	26%

The debt to capitalization ratio and debt to net plant assets ratio provide an indication of the leverage of the utility. There is not a target leverage ratio that is ideal for all utilities but, generally, the lower the

leverage ratio, the more financial flexibility the utility has and the easier it is for the utility to finance its capital needs. As a point of reference, in a recent Fitch Ratings report (Fitch Medians)¹, the median value of debt to net plant assets for small systems (defined as utilities serving fewer than 100,000 persons) was 36%. Thus, WOWSC is less leveraged than the Fitch median small system by this metric. It is important to note that WOWSC is significantly smaller than the average system defined as a small system by Fitch.

Table 2
Debt Service Coverage

	2017	2018	2019
Available for Debt Service	\$ 85,606	\$ 91,885	\$ 55,681
Debt Service	50,118	50,104	50,089
Ratio	1.71	1.83	1.11

Debt service coverage is a measure of financial flexibility that judges a utility's financial margin to pay debt service from net revenues after priority expenses, such as operation and maintenance (O&M) expenses, are paid. It is common for utility debt covenants to have a requirement for debt service coverage, such as 1.25. WOWSC's debt service coverage decreased precipitously in 2019 due, in large part, to lawsuit expenses. The Fitch Medians report indicates the median debt service coverage for small systems was 2.6, which is significantly higher than WOWSC's current debt service coverage despite the fact that WOWSC has relatively low leverage. A key benefit of sufficient debt service coverage is that it indicates revenue in excess of cash O&M that can be used to cash fund some portion of capital expenses.

Table 3
Days Cash on Hand

	2017	2018	2019
Actual Results			
Liquid Assets	\$ 144,112	\$ 168,542	\$ 150,994
Less: Capital Expenditure Reserve	(47,158)	(41,983)	(41,983)
Net Unrestricted Reserves	\$ 96,954	\$ 126,559	\$ 109,012
Total Cash Operating Expenses	\$ 291,019	\$ 371,260	\$ 503,795
DCOH	122	124	79
Modified Results if There Were No Lawsuits			
Lawsuit Related Legal Costs ^(a)	\$ -	\$ 25,480	\$ 159,173
Modified Net Unrestricted Reserves	96,954	152,039	293,665
Modified Cash Operating Expenses	291,019	345,780	344,622
DCOH (hypothetical)	122	160	311

(a) Includes costs directly related to ongoing lawsuits as well as general counsel services for Public Information Act requests

¹ Fitch Ratings, 2019 Water and Sewer Medians, Public Finance, November 12, 2018.

Days cash on hand (DCOH) serves as an indication of liquidity or ability to meet short-term liabilities, particularly under unforeseen hardships. This is generally calculated as current unrestricted cash and investments, divided by annual cash operating expenditures, divided by 365 days in a year. The Fitch Medians report indicates the median DCOH for small systems was 627.

As shown in Table 3, WOWSC's actual DCOH has been declining significantly as a result of lawsuit expenses. Table 3 also shows a hypothetical DCOH based on what NewGen estimates would have been the financial impact if WOWSC had not had the lawsuit expenses (with all else equal). WOWSC took action in February 2020 to increase water and sewer rates to help mitigate the financial impact of the lawsuits. WOWSC's financial condition would be significantly improved, and rates could be lowered, if all outstanding legal disputes were resolved.

Current Conditions

NewGen developed a financial projection for 2020 based on the WOWSC 2020 budget (with a few line items adjusted), current rates, new CoBank loans, and assumed lawsuit expenses, as shown in Exhibit A. The analysis indicates WOWSC will essentially breakeven on a cash basis if lawsuit expenses are limited to approximately \$245,000 in 2020. It is worth noting that WOWSC has been billed for approximately \$169,000 for legal expenses related to the lawsuit as of May 2020. Thus, further financial deterioration is possible if legal expenses do not abate despite the significant increase in rates approved in February 2020.

Financial Policies

It is good governance for utilities to have written financial policies to guide the utility and ensure consistent decision-making over time. NewGen is not aware of any written financial policies for WOWSC. Therefore, we suggest the following possible financial policies for consideration by WOWSC. Not all of these policies may be needed or appropriate. Further, the inclusion of one policy may impact the stated target of another policy. For example, whether or not WOWSC opts to maintain an emergency reserve fund may alter the number of days cash O&M WOWSC targets for its operating reserve. Utilities that employ financial policies, such as the ones suggested below, tend to be rewarded with better interest rates from lenders and more favorable terms for financing. Further, financial policies can help guide consistent, optimal decision-making.

To be clear, the targets listed in the financial policies below are merely suggestions. The actual targets appropriate for each of the policies below should be selected by the WOWSC Board based on WOWSC's priorities, values, and risk tolerance. WOWSC may not need to adopt all of the suggested policies listed below but, rather, may pick and choose the policies that are appropriate for WOWSC.

List of Possible Financial Policies

- The term of debt generally shall not exceed the useful life of the asset financed, and shall not generally exceed 30 years.
- Debt service coverage of at least 1.50x shall be targeted (and actual debt service coverage shall be in compliance with all relevant debt covenants).
- Ongoing routine, preventive maintenance should be funded on a pay-as-you-go basis.
- Capital projects should be financed through a combination of cash, referred to as pay-as-you-go financing (equity contributions from current revenues), and debt. An equity contribution ratio of at least 15% is desirable.

- The utility shall maintain operating cash reserves equivalent to a minimum of 90 days of budgeted cash operations and maintenance expense.
- The utility shall maintain an emergency reserve with a minimum of 30 days of budgeted cash operations and maintenance expense.
- The utility shall maintain a repair and replacement reserve with a target balance of 50% of current year depreciation.
- Rates shall be designed to generate sufficient revenues to support the full cost of operations and debt; provide debt service coverage and meet other debt covenants, if applicable; and ensure adequate and appropriate levels of reserves and working capital.

New Fair Market Value Process

The 86th Texas Legislature passed House Bill 3542, which established a fair market valuation process that may be used by Class A or Class B water or sewer utilities acquiring another retail public utility (or facilities of another retail public utility).² This new fair market valuation process provides an acquiring utility the opportunity to put more than original cost less depreciation into rate base (i.e., a positive acquisition premium). Rate base for regulated utilities, such as investor-owned utilities (IOUs), is the invested capital on which they are allowed the opportunity to earn a return. Traditional rate regulation limits the primary component of rate base to original cost less depreciation. Thus, the opportunity to put a positive acquisition premium into rate base is attractive to the acquiring rate regulated utility. The presumed goal of House Bill 3542 was to make it more attractive for larger, more efficient and well financed utilities to acquire smaller and/or distressed utilities. The target utilities may be less efficient due to the scale of their operations or may lack access to sufficient funding to invest in facilities to improve service or satisfy regulatory requirements.³ Thus, although a positive acquisition premium may result in higher rates for the customers of the acquired system, there is the potential benefit to customers of more efficient operations and/or improved service or regulatory compliance. Consolidating systems within a larger entity has the potential to achieve greater economies of scale and spread capital cost recovery over more customers, benefiting ratepayers.

While each situation is different, and there can be benefits of IOU ownership, it is important to note that IOUs have structural cost disadvantages as compared with not-for-profit entities, such as WOWSC. First, an IOU's return on investment, as established by the PUCT, includes profit that a not-for-profit entity does not require. Second, the IOU must pay taxes (property taxes, sales taxes, and income taxes) that a not-for-profit entity does not pay. Thus, in order for the IOU to charge the same or similar rates as the not-for-profit entity, the IOU must operate more efficiently than the not-for-profit entity in order to overcome these structural cost disadvantages and still generate a return for its investors. Further, whereas important decisions for WOWSC, such as rate-setting or impacts to community aesthetic, are made by a board that is elected by the customers, customers of IOUs must rely on the PUCT to ensure that rates, policies, and decisions are just, reasonable and in the public interest of all ratepayers. Thus, there is some loss of control that would accompany a transition from WOWSC's current governance structure to IOU ownership.

² The new rules were adopted by the PUCT in Docket No. 49813.

³ NewGen is in no way implying that WOWSC is inefficient or lacks access to sufficient capital funding. These are simply example attributes that are sometimes cited when discussing candidate target utilities under the fair market valuation process.

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We appreciate the opportunity to assist WOWSC. If there are any questions regarding this financial assessment, please feel free to contact me.

Sincerely,

NewGen Strategies and Solutions, LLC

A handwritten signature in black ink that reads "Grant Rabon". The signature is written in a cursive style with a large, prominent initial "G".

Grant Rabon, Executive Consultant

Windermere Oaks Water Supply Corp

Exhibit A

		Actual 2017	Actual 2018	Actual 2019	Budget 2020	Adjustments	Projected 2020	Notes
		A	B	C	E	F	G	H
1	Revenue							
2	Standby Fees	\$ 41,977	\$ 38,959	\$ 44,079	\$ 33,000	\$ 11,079	\$ 44,079	A
3	Service	279,873	341,066	369,541	390,000	145,553	535,553	B
4	Late Charge	6,750	8,575	5,092	5,000		5,000	
5	Membership Transfer Fees	70	350	(1,982)	2,800	(2,800)	-	C
6	Equity Buy-In Fees	24,000	41,800	50,600	27,600	18,400	46,000	D
7	Tap Fees	8,250	16,425	20,700	10,350	13,900	24,250	D
8	Reconnect Fee	35	-	-	-		-	
9	Miscellaneous	-	2,035	59,149	-		-	
10		\$ 360,956	\$ 449,211	\$ 547,180	\$ 468,750		\$ 654,882	
11	Other							
12	Interest Income	\$ 362	\$ 331	\$ 481	\$ 300		\$ 300	
13	Property Sales	-	-	-	-		-	
14		\$ 362	\$ 331	\$ 481	\$ 300		\$ 300	
15								
16	Total Revenue	\$ 361,318	\$ 449,543	\$ 547,661	\$ 469,050		\$ 655,182	
17								
18	Operating Expenses							
19	Operator	\$ 109,800	\$ 116,825	\$ 117,865	\$ 123,375		\$ 123,375	
20	Chemicals	10,425	10,602	12,035	12,450		12,450	
21	Electricity	20,143	21,585	20,922	22,400		22,400	
22	Sludge Removal	8,095	4,521	2,363	5,000		5,000	
23	LCRA Raw Water Fee	8,551	8,468	8,490	9,000		9,000	
24	Lab Fees	5,244	7,166	8,459	6,500		6,500	
25	Website	358	358	-	500		500	
26	New Service Taps	15,455	10,462	20,985	7,200	17,050	24,250	E
27	Bank Charges	481	411	222	600		600	
28	Accounting	4,263	6,465	5,848	17,800		17,800	
29	Billing Services	15,928	14,350	15,679	20,000		20,000	
30	Contract Services	2,657	4,783	3,069	9,000		9,000	
31	Legal and Appraisal	2,247	12,501	7,411	-	7,386	7,386	F
32	Legal - Lawsuit Related	-	25,480	159,173	110,000	135,223	245,223	G
33	Dues and Subscriptions	2,552	1,835	178	4,000		4,000	
34	TCEQ Fees	1,818	1,816	1,816	2,100		2,100	
35	Insurance	12,577	14,083	14,161	21,000		21,000	
36	Meals and Entertainment	-	131	-	500		500	
37	Office Supplies	1,570	1,283	4,707	3,400		3,400	
38	Telephone and Internet	4,156	4,526	6,549	6,000		6,000	
39	Postage and Shipping	2,510	2,094	2,710	5,000		5,000	
40	Equipment Rental	-	-	250	1,500		1,500	
41	Repairs and Maintenance	35,481	76,824	71,060	50,000	11,121	61,121	F
42	Repair Parts	8,468	7,523	6,730	16,000		16,000	
43	Printing	-	2,184	168	1,500		1,500	
44	Interest	15,307	13,603	11,815	14,000	28	14,028	H
45	Taxes - Property	-	-	-	40		40	
46	Meetings and Conferences	2,933	1,382	1,130	2,500		2,500	
47		\$ 291,019	\$ 371,260	\$ 503,795	\$ 471,365		\$ 642,174	
48								
49	Net Income before Depreciation	\$ 70,300	\$ 78,283	\$ 43,866	\$ (2,315)		\$ 13,008	
50								
51	Debt Principal	\$ 34,812	\$ 36,502	\$ 38,274	\$ -	13,008	\$ 13,008	H
52								
53	Net Cash Flow before Cash Capital Outlay	\$ 35,488	\$ 41,781	\$ 5,592	\$ (2,315)		\$ -	I

Notes:

- A Assumed to be the same as in 2019
- B Forecasted based on eight months at current rates and four months at prior rates as well as 10 additional water and sewer customers in 2020
- C Assumed to be \$0 based on recent actual fees
- D Based on 10 water and sewer customers added per year
- E Assumed to be equal to the tap fee revenue
- F Based on an average of the actual results for the last three years
- G Estimate for this analysis; includes costs directly related to ongoing lawsuits as well as general counsel services for Public Information Act requests
- H Based on CoBank estimates for loans in the amounts of \$230,000 and \$150,000
- I Assumes bad debt does not increase significantly